

In Focus

Cement

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Cement: Interest rate decline in FY10 to improve profitability

- Plagued by high debt structures most of the cement industry saw profits either being reduced significantly or turning into losses because of high cost of debt during FY09
- Some of the severely impacted companies include D.G. Khan Cement, Lafarge Cement, Bestway Cement and Kohat Cement. Please refer to table for Debt to equity ratios
- Given the declining interest rate environment, cement sector not only stand to benefit from lower financial charges but will also be a likely beneficiary of increased cement offtake and revival in industrial/commercial activities
- Companies exhibiting dispatch growth, high coverage and DoFL, are prime beneficiaries of interest rate declines; Bestway, D.G. Khan, Fauji, Kohat, Lafarge, Al-Abbas and Maple Leaf exhibit both high DoFL and good coverage ratios
- D.G. Khan and Lafarge are the only two of these companies which have reduced their debt during FY09
- The companies that have shown both revenue growth, low debt to equity ratio and good coverage ratio (irrespective of their financial leverage) are Thatta Cement, Lucky Cement and Cherat Cement
- We maintain an **OVERWEIGHT** stance on the sector with our top being **LUCK** which offers a potential upside of 26% to our DCF based Fair Value of PKR88/share

The Cement industry of Pakistan was significantly impacted by finance costs during FY09. Plagued by high debt structures most of the industry saw profits either being reduced significantly or turning into losses because of high cost of debt. With interest rate declining there are hopes for operating improvements and revenue growth to improve the bottom-line for many of these companies.

Some of the severely impacted companies include D.G. Khan Cement, Lafarge Cement, Bestway Cement and Kohat Cement. Please refer to table for Debt to equity ratios.

Degree of Financial Leverage and Finance Coverage: Turnaround in the making

DoFL is a ratio used to measure the Earnings per share (EPS) change to changes in Earnings before Interest and Taxes (EBIT). Since financial charges constitute the only major expense item between EBIT and Earnings, DoFL indirectly indicates the changes in profitability due to changes in financial costs involved.

As mentioned before, cement industry in Pakistan at an overall level has exhibited high debt structures. Due to this, some of the companies have exhibited high DoFL, in some cases where financial charges are greater than EBIT (an extreme case of high financial costs) it exhibits a negative number.

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Select Leverage Ratios for Listed Cement Companies

Company name* 9M data FY09	DOFL	Interest Coverage	Cash Coverage	Debt to Equity	Increase / (Decrease) in Debt	Dispatch Growth (Jul-Mar comparison.)
Bestway Cement Ltd.	2.92	1.52	(0.30)	1.70	1,144,801	25%
Cherat Cement Company Ltd.	1.48	3.09	2.14	0.70	936,762	1%
Dandot Cement Ltd.	0.23	(0.30)	0.15	1.51	(29,531)	36%
D.G.Khan Cement Ltd.	28.99	1.04	0.58	0.80	(1,179,534)	-10%
Fauji Cement Company Ltd.	1.21	5.82	3.33	0.27	1,041,514	-10%
Flying Cement Ltd.	0.87	(6.74)	(4.85)	0.17	267,723	180%
GharibWal Cement Ltd.	0.36	(0.57)	16.70	1.38	6,653,122	0%
Kohat Cement Company Ltd.	(6.40)	0.86	(0.37)	1.64	396,924	66%
Lucky Cement Ltd.	1.29	4.50	4.36	0.46	1,465,474	5%
Maple Leaf Cement	(1.71)	0.63	0.92	1.49	60,314	13%
Lafarge Pakistan Cement	(0.29)	0.22	4.24	0.55	(865,311)	-32%
Pioneer Cement Ltd.	3.71	1.37	2.41	0.58	(240,435)	-35%
Al-Abbas Cement Ltd.	(9.59)	0.91	(0.98)	1.14	266,206	132%
Dewan Cement Ltd.	0.05	(0.05)	(0.16)	0.76	541,577	3%
Thatta Cement Ltd.	1.24	5.13	2.25	0.36	(40,858)	16%
Zeal Pak Cement Ltd.	0.82	(4.69)	(0.03)	0.28	20,229	72%

Source: Company Financial Reports, BMA Research

When put in perspective with interest coverage and cash coverage ratios, DoFL can help identify companies that can significantly improve their profitability in upcoming FY10 as interest rates decline.

Companies exhibiting dispatch growth, high coverage and DoFL, are prime beneficiaries of interest rate declines; Bestway, D.G. Khan, Fauji, Kohat, Lafarge, Al-Abbas and Maple Leaf exhibit both high DoFL and good coverage ratios. D.G. Khan and Lafarge are the only two of these companies which have reduced their debt during FY09.

Other Considerations

Although the aforementioned companies are possible beneficiaries in the scenario of interest rate decline, it is important to note the companies that have shown both revenue growth, low debt to equity ratio and good coverage ratio (irrespective of their financial leverage).

Thatta cement, Lucky cement and Cherat cement fall under this category. They exhibit profitability and generation of cash which is important in times when liquidity has dried up in the prevalent market. Positive Earnings and CFO improve the quality of earnings and can help extinguish high cost debt.

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Outlook: Maintain OVERWEIGHT stance on the sector – Lucky Cement the Top Pick

Given the declining interest rate environment, cement sector not only stand to benefit from lower financial charges but will also be a likely beneficiary of increased cement offtake and revival in industrial/commercial activities. 6M KIBOR which averaged at 13.79% during FY09 is projected to average at 10% in the current fiscal year – a straightaway decline of 27.5% in financial charges if outstanding debt is to stay at the same level!

While this note identifies the companies that are likely to post the most significant profitability turnaround; we would like to reiterate our top pick from the sector – LUCK which is trading at FY09E and FY10E PERs of 5.4x and 5.1x, respectively. The stock offers a potential upside of 26% to our DCF based Fair Value of PKR88/share.